ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Nakano	Analyst:	John Pavalasky	Bill Number:	AB 894
Related Bills:	See Legislative History	Telephone:	845-4335	Amended Date:	April 17, 2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Bank & Corporation Capital Loss Limitation/Election Of Credit For Excess Net Tax Liability

SUMMARY

This bill would:

- allow capital losses to offset any other income of a corporation, and
- allow a carryover credit to a corporation to the extent that the corporation would have paid less in tax had capital losses been treated in this manner in prior years.

SUMMARY OF AMENDMENTS

The April 17, 2001, amendments:

- change all references to the year 2000 to 2001,
- change all references to the year 1995 to 1996,
- change all references to the year 1994 to 1995, and
- change the reference to net operating loss (NOL) percentages from "50 percent" to "applicable percentage."

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to treat capital losses in the same manner as ordinary income or losses.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSIS

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	04/30/2001
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING		

FEDERAL/STATE LAW

State law generally conforms to federal law relating to the computation of gain or loss on the disposition of capital assets.

Federal law (IRC Section 1221) provides that capital assets are property other than: stock in trade or other inventory-type property held primarily for sale to customers; depreciable or real property used in a trade or business; patents held as inventory, copyrights, and other literary property; accounts or notes receivable acquired in the ordinary course of business; and U.S. government publications, as specified.

Generally, capital gain is realized and recognized when a capital asset is sold or otherwise disposed of and the amount realized exceeds the basis of the asset and the amount subject to recapture under federal law. Basis in a capital asset is determined by the cost of the asset and is increased by further investment or decreased by allowable deductions. A capital loss results when a capital asset is sold or otherwise disposed of and the amount realized is less than the basis of the asset. Generally, any gain or loss from the sale or other disposition of property that does not qualify as a capital asset is ordinary gain or loss.

IRC Section 1231 gains and losses arise from certain dispositions of Section 1231 property. Section 1231 gains are gains from (1) the sale or exchange of depreciable personal or real property used in a trade or business (not mere investment) and held for more than one year and (2) the conversion of business or investment property held for more than one year. Section 1231 losses are losses from the sale or exchange or conversion of business or investment property held for more than one year. Generally, if Section 1231 gains exceed Section 1231 losses, the net gains are treated as long-term capital gains. If Section 1231 losses exceed Section 1231 gains, the losses are ordinary losses. Section 1231 gains must be treated as ordinary income to the extent of the taxpayer's net Section 1231 losses in the preceding five years.

Federal law (IRC Section 1222) provides rules relating to the netting of capital gains and losses. Short-term capital gains are netted with short-term capital losses to arrive at net short-term capital gains/losses. Long-term capital gains are netted with long-term capital losses and net Section 1231 gains to arrive at net long-term capital gains/losses. Net short-term capital gains/losses and net long-term capital gains/losses are netted. If a net gain results, then that gain is included in income. If a net loss results, it is not currently deductible for corporations, but up to $3,000 may be deductible for individuals.

Under current **federal and state law**, corporations may deduct capital losses only to the extent of capital gains. **Federal law** generally permits a three-year carryback and a five-year carryforward for excess capital losses. **State law,** however, permits only a five-year carryforward for excess capital losses with no carryback.

Current California law, in Regulation Section 25106.5, relating to combined reporting, provides for the intrastate apportionment of business gains or losses from the sale or exchange of:
- capital assets;
- Section 1231 property; and
- involuntary conversions,

prior to the section 1221 capital gain/loss netting provisions. Those gain/loss items are then netted at the entity level after intrastate apportionment.

Under current **federal law** the tax on net capital gains for corporations is limited to a maximum rate of 35%, that only applies when the top corporate rate on ordinary income exceeds 35%. Since the generally applicable maximum rate on corporate ordinary income for the year 2000 is 35%, this capital gain tax limitation has no current effect.

Under current **state law**, capital gains for corporate taxpayers are taxed under the Bank and Corporation Tax Law (B&CTL) at the same rates as ordinary income (8.84%), with no maximum capital gain rate. Thus, under current **federal and state law**, corporate taxpayers are taxed on capital gains at the same rates as on ordinary income.

<u>THIS BILL</u>

This bill would repeal the capital loss limitation and carryover provision for corporations for taxable years beginning on or after January 1, 2001.

Allowing the deduction of the current year's capital loss would return California law to the way it was prior to the state's conformity with the federal capital loss limitation rules.

Capital loss carryover amounts from taxable years beginning before January 1, 2001, would continue under the current rules (i.e., capital losses may be deducted only to the extent of capital gains and excess capital losses may be carried forward for five years).

In addition, this bill would allow a taxpayer under the B&CTL to make an *irrevocable election*, in lieu of the treatment of capital loss carryovers under this bill and in regulations promulgated under section 25106.5, on a timely filed original return, for its first taxable year beginning on or after January 1, 2001, to do each of the following:

a) Recompute its tax liability each year from 1990-2000 as though capital losses had not been limited in those years and net that aggregate amount against the actual aggregate tax liability for each year from 1990-2000.

In performing this recomputation:
- capital losses taken into account for the period from 1990-1995 are limited to the capital gain of the unitary group before apportionment during that same period.
- if the deduction of the capital loss for the year creates or increases a NOL for that year, 100% of the NOL attributable to the capital loss deduction may be carried forward under the NOL rules rather than being reduced by the applicable percentage. However, all other NOL modifications made by California to the federal NOL rules would apply. Unused NOL carryovers remaining from the recomputation years would be allowed to be carried forward into the year 2001 and subsequent years under the California modified NOL rules.

b) Claim a credit against the taxpayer's tax liability starting in the year 2001, and succeeding years until used, to the extent that actual aggregate tax liability for the period 1990-2000 exceeds the aggregate recomputed tax liability for those years.

This bill provides that in cases where a combined reporting group makes the election under this bill, all of the members of the group must make the election. A key corporation filing a group return may make this election on behalf of all members of the group. This bill also would allow current and former members of the combined reporting group to assign any portion of the credit to be used by any other member or former member of the combined group. Unused credits may be reassigned each year.

LEGISLATIVE HISTORY

AB 1208 (Revenue & Taxation Committee 1999/2000) contained, as one of its many provisions, a Franchise Tax Board sponsored proposal that would have repealed the capital loss limitation and carryover provision for corporations for taxable years beginning on or after January 1, 2000. Capital loss carryover amounts from taxable years beginning before January 1, 2000, would have continued under the current rules (i.e., capital losses may be deducted only to the extent of capital gains and excess capital losses may be carried forward for five years). That bill failed passage out of the Assembly. SB 843 (Polanco, 1999/2000, as amended August 31, 2000) contained the same provision contained in AB 1208. SB 843 was held in the Senate Appropriations Committee.

PROGRAM BACKGROUND

In 1990, **California law** adopted the federal statutes concerning capital loss limitations and made no modifications to address combined reporting issues. The federal law is based on a single entity approach. However, federal regulations provide special rules for federal consolidated returns so the capital loss limitation is applied on a group basis. Since California law does not conform to the federal consolidated return provisions, the federal regulations relating to consolidated returns do not apply.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* generally conform to federal law relating to the limitation on deducting capital losses on the disposition of capital assets by corporations and the carryover and carryback of excess losses. However, unlike federal law, Florida and Minnesota do not allow any capital loss carrybacks.

Those states were examined due to similarities to California of those states' population and business activity.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Tax Revenue Estimate

The projected revenue impact for these changes is as follows over the initial three years:

Estimated Revenue Impact of AB 894 As Amended April 17, 2001 (In Millions)			
	2001-2	2002-3	2003-4
Retroactive Impact	-$8	-$4	-$1
Prospective Impact	-$5	-$2	-$1
Total	-$13	-$6	-$2

It is assumed enactment would be after June 30 of this year.

Tax Revenue Discussion

Revenue losses under this bill would be determined by the amount of additional corporate capital losses that can be applied to reduce state tax liabilities from specified retroactive and prospective applications.

This analysis is based on very limited tax return information pertaining to unapplied capital losses and, therefore, is largely based on the judgment of staff. The revenue loss projections for retroactive applications are somewhat less than those used previously for a virtually identical proposal to amend R&TC section 24990.5. The change represents a correction to our understanding regarding the use of capital losses for these prior years under current law conditions. The effect of this correction was to reduce the magnitude of unapplied capital losses available under the proposal for those earlier years.

SUPPORT/OPPOSITION

A. In 1999 the Franchise Tax Board (FTB) sponsored legislation to repeal the capital loss limitation and carryover provision for corporations while retaining the current rules (i.e., capital losses may be deducted only to the extent of capital gains and excess capital losses may be carried forward for five years) with respect to capital loss carryovers. No credit election was contained in that sponsored legislation.

B. The FTB has not taken a position regarding the credit contained in this bill.

ARGUMENTS/POLICY CONCERNS

- The repeal of the capital loss limitation provision for 2001 and later years could cause a corporate taxpayer to lose as much as 45% of the capital loss amount if the taxpayer has a net loss (without regard to capital losses) for the year the capital loss is recognized. That is because the carryover would be subject to California's NOL rules, that in 2001, generally permit only 55% of an operating loss to be carried forward as a NOL (subject to certain exceptions not relevant to this bill). In contrast, under current law, 100% of the excess capital loss would be carried forward and could be absorbed in future years if the corporate taxpayer had sufficient capital gains within the succeeding five years.

- For taxpayers subject to worldwide combined reporting, the necessary data to identify unitary business transactions as capital, ordinary, Section 1231, or involuntary conversion are not likely to be accessible to the California taxpayer members of the group, because that information is not otherwise required to be kept in that form.

  Foreign controlled worldwide filers generally start with financial accounting data and make adjustments to accommodate California law. These filers do not keep accounting records that separately track activities as ordinary or capital transactions. The costs associated with literal compliance with the law are likely to be high. Statistical sampling is not likely to be an effective technique for estimating the amount of capital gain/loss, Section 1231 gain/loss, and involuntary conversion gain/loss for worldwide filers, because of the non-uniform, irregular and sometimes extraordinary generation of such income.

  Further, while domestic corporations are required to identify capital gains and losses for federal tax purposes, the calculations required for California are much more complex than for federal purposes.

  Thus, for both worldwide combined reporters and domestic corporations, the cost of compliance with the current law capital loss limitation and carryforward provisions are high.

- If the intention of this bill is to treat the capital loss provisions as if they had never been enacted (except for timing effects), then to treat all taxpayers as if they were governed by the same rules for those years, an additional tax would have to be imposed to take away the benefits enjoyed by some taxpayers in earlier years resulting from capital loss conformity.

- The computations under this bill would be extremely complicated. The taxpayer would have to make two computations, one under this bill and the other under current rules, to determine whether the election should be made. Taxpayers would be required to gather records that are over 11 years old, and some of those records may be in the possession of entities that are no longer part of the combined reporting group.

- The election to assign the credit among current or former members of a combined group varies from the general practice of the legislature as it relates to the treatment of tax credits where a credit is earned by a member of a unitary group.

- The credit election covers the entire period from the inception of the law change and not just those years that the loss carryover period has expired and the unused losses are therefore lost. If the purpose of the bill is to allow these so called "trapped" losses to be utilized to the extent of the capital gain of the combined group as a whole, then the relief proposed by this bill is broader than that problem.

- This bill allows the credit only if the net reduction in tax liability is due to unused capital loss. However, it is difficult to determine whether this causal relationship exists. For example, if a taxpayer had operating losses in an earlier year as well as capital losses, and the capital loss is allowed to be taken in full before the operating losses, it could be argued that it was the operating losses that caused the net reduction in tax liability for that year.

- In general, tax treatment of various items under the Personal Income Tax Law (PITL) and B&CTL are consistent. This provision would make the treatment of capital losses different under the PITL and B&CTL. However, there are currently differences between PITL and B&CTL treatment of capital losses, as well as with respect to certain capital gains (e.g., qualified small business stock rules apply only to PITL taxpayers).

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